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In the Supreme Court of the United States

OCTOBER TERM, 1978

TENNESSEE-CAROLINA TRANSPORTATION, INC.,
PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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The question presented in this federal income tax case is whether the courts below correctly held that the tax benefit rule requires a corporation to include in its income at the time of liquidation the fair market value of assets it distributes to its parent corporation when it had previously claimed a business expense deduction for the cost of those assets.

The facts are undisputed and may be summarized as follows: During 1966, Service Lines, Inc., a corporation then engaged in the motor freight transportation business, purchased truck tires and tubes, at a cost of $53,000. Because the tires and tubes had a useful life of no more than one year, Service deducted the $53,000 purchase price as a business expense on its 1966 tax return. In 1967, petitioner purchased 100% of Service's stock and thereafter liquidated Service and took direct possession of

Service's assets. Pursuant to Section 334(b)(2) of the Internal Revenue Code of 1954, petitioner claimed a stepped-up basis in the previously-expensed tires and tubes to reflect their value ($36,000) as of the date of liquidation. Petitioner thereafter claimed a $36,000 deduction with respect to those tires and tubes (Pet. App. A-2 to A-5; Pet. App. B-2).

On audit, the Commissioner of Internal Revenue determined that Service was required to include in its income at the time of the liquidation the fair market value of the tires and tubes it distributed to petitioner. In a reviewed opinion with seven judges dissenting, the Tax Court upheld the Commissioner's determination (Pet. App. A-1 to A-13).

The court of appeals affirmed (Pet. App. B-1 to B-9), with one judge dissenting (Pet. App. B-10 to B-20). It held that the tax benefit rule required Service to include the previously-expensed tires and tubes in income because there was an inconsistency between Service's expense deductions and petitioner's (Service's successor) claim to a tax basis in that same property. In so ruling, the court cited petitioner's concession that if Service had liquidated under Section 337, the tax benefit rule would have required that Service report as ordinary income the fair market value of the tires and tubes that it previously claimed as a business expense. In the court's view, "[t]here is no reason in either the statute or tax policy for reaching a different result in this case merely because Service and [petitioner] chose a §336 liquidation" (Pet. App. B-5).

1. One of the fundamental principles upon which the federal income tax is based is that income and expenses are computed in accordance with a system of annual accounting. *Burnet* v. *Sanford & Brooks Co.*, 282 U.S. 359 (1931). Under this system, items of income and expenses properly accruable and attributable to a particular taxable year must be reported on the return for the year even

though circumstances may subsequently prevent the receipt of such income or the payment of such expenses. For those events, the annual accounting system requires that any adjustments made as a result of changed circumstances occurring in a subsequent year must be reported on the return for the subsequent year and not for the year in which the items were originally reported. See *Healy* v. *Commissioner*, 345 U.S. 278 (1953).

The "tax benefit" rule is a judicial doctrine that is a corollary of the annual accounting system. Under this rule, amounts deducted from gross income in one taxable year but "recovered" in a subsequent year must be included in income in the year of recovery. Thus, for example, if a taxpayer deducts state income taxes under Section 164 of the Code and those taxes are refunded to him in a subsequent year, he must include the tax refund in his federal taxable income. As the Court of Claims observed in *Alice Phelan Sullivan Corp.* v. *United States*, 381 F. 2d 399, 401 (1967): "[T]he principle is well engrained in our tax law that the return or recovery of property that was once the subject of an income tax deduction must be treated as income in the year of its recovery." See, *e.g.*, *Dobson* v. *Commissioner*, 321 U.S. 231 (1944); *Burnet* v. *Sanford & Brooks Co.*, *supra*; *Home Savings and Loan Ass'n* v. *United States*, 514 F. 2d 1199 (9th Cir.), cert. denied, 423 U.S. 1015 (1975). Cf. Internal Revenue Code of 1954, Section 111; *United States* v. *Skelly Oil Co.*, 394 U.S. 678 (1969).

The decision below correctly held that the tax benefit rule required Service to include the liquidation value of the tires and tubes in its income. Here, Service purchased $53,000 worth of tires and tubes during 1966 and claimed a business expense deduction for that year equal to their full cost on the assumption that they would be consumed in one taxable year. Rev. Rul. 59-249, 1959-2 Cum. Bull. 55. But subsequent events undermined the basis for that

assumption. As of its liquidation into petitioner, Service had not completely consumed the tires and tubes in its business. To the contrary, those items were still worth $36,000 when Service distributed them in 1966 to petitioner as a liquidating distribution. The fact that petitioner claimed a tax basis in the equipment equal to its fair market value as of Service's liquidation shows that they had value in that amount so as to cast doubt upon Service's previously claimed deduction. Under these circumstances, the tax benefit rule requires the inclusion in Service's income of the value of the tires and tubes. As the court of appeals observed (Pet. App. B-7), "[t]his transfer belied the assumption that they would be wholly consumed by Service. Thus, in order for Service to be able to transfer them to taxpayer they must be deemed to have been recovered by Service at that time."

2. Contrary to petitioner's contention (Pet. 8), the decision below does not conflict with Section 336 of the Code. That provision states that "no gain or loss shall be recognized to a corporation on the distribution of property in partial or complete liquidation." But as the court of appeals correctly pointed out (Pet. App. B-4 to B-5), it is well settled that the similar nonrecognition rule of Section 337 applicable to liquidating corporations does not bar the application of judicial doctrines such as assignment of income or the tax benefit rule. Thus, for example, if Service had liquidated under Section 337 and sold its tires and tubes for $36,000, the tax benefit rule would have required it to include that $36,000 in income notwithstanding the terms of Section 337, which permit the nonrecognition of gain from the sale of property by a liquidating corporation. See, *e.g.*, *Commissioner* v. *Anders*, 414 F. 2d 1283 (10th Cir.), cert. denied, 396 U.S. 958 (1969); *Spitalny* v. *United States*, 430 F. 2d 195 (9th Cir. 1970). Similarly, the assignment of income doctrine has been held to require a corporation to recognize income with respect to a liquidating distribution of work

in process despite the nonrecognition rule of Section 337. *Storz* v. *Commissioner*, 583 F. 2d 972 (8th Cir. 1978); *Midland-Ross Corp.* v. *United States*, 485 F. 2d 110 (6th Cir. 1973). As the court of appeals correctly concluded, "[t]here is no reason in either the statute or tax policy for reaching a different result in this case merely because Service and [petitioner] chose a §336 liquidation" (Pet. App. B-5).

Nash v. *United States*, 398 U.S. 1 (1970), upon which petitioner relies (Pet. 5-6), is distinguishable. There, this Court held that the tax benefit rule did not require the members of a partnership to include in income the amount of bad debt reserves attributable to the partnership's accounts receivable upon the partnership's Section 351 transfer of its assets to a corporation in exchange for stock. In so holding, the Court rejected the Commissioner's argument that the winding up of the partnership's business terminated its need for the bad debt reserve and that termination was a recovery of an item that produced an income tax benefit within the ambit of the tax benefit rule. As the Court viewed the matter, since the value of the stock was equal to the net value of the receivables (face amount less the reserve), there was no recovery of any item.

Here, however, Service transferred equipment to petitioner that Service had entirely written off but which had an undisputed value of $36,000, as demonstrated by petitioner's claim of basis in that amount. As the court of appeals correctly observed (Pet. App. B-8), "Thus, unlike the instant case, in *Nash* the taxpayers did *not* transfer an item (or any portion thereof) which had been the subject of a prior deduction, but rather transferred only what was left after the deduction. Here, Service clearly transferred items which had been the subject of prior deductions" (emphasis in original). See Rev. Ruls. 78-278, 78-279, 1978-30 Int. Rev. Bull. 5, 6 (July 24, 1978).

3. Finally, petitioner argues (Pet. 4-5, 7) that the decision below conflicts with *Commissioner* v. *South Lake Farms, Inc.*, 324 F. 2d 837 (9th Cir. 1963). There, a corporation liquidated and transferred its assets (unharvested crops with respect to which it had claimed growing expenses) to a second corporation which owned all of its stock. The Commissioner sought to include in the income of the liquidating corporation the liquidation date value of its unharvested crops under Section 446(b) or alternatively deny it a deduction for the crop growing expenses under Section 482. The Tax Court rejected both contentions (36 T.C. 1027 (1961)). In the court of appeals, the Commissioner abandoned his Section 482 argument and relied solely upon Section 446(b), which provides that "if the method [of accounting] used [by a taxpayer] does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the [Commissioner], does clearly reflect income."

A divided court of appeals affirmed. It ruled that no method of accounting would have required the liquidating corporation to include the value of its unharvested crops in income. It further held that Section 446(b) could not be used to disallow the crop growing expenses to the liquidating corporation. As the court stated, "[t]o use section 446(b) in this case as proposed would, we think, circumvent the provisions and purposes of sections 334 and 336 of the Code" (324 F. 2d at 839). In so holding, the court rejected the Commissioner's argument that the liquidating corporation received a tax benefit from the crop growing expenses and recovered that item through an enhanced price upon the sale of its stock.

To be sure, the Ninth Circuit's observations in *South Lake Farms* with respect to Section 336 are not entirely consistent with the analysis of the court below. Thus, the court of appeals in this case rejected the authority in *South Lake Farms* (Pet. App. B-6 n.13) and the

dissenting judge heavily relied upon it (Pet. App. B-15 to B-17). But the decision in *South Lake Farms* can be read as principally turning upon the Ninth Circuit's view that the Commissioner's authority under Section 446(b) to prescribe methods of accounting did not extend to the disallowance of the liquidating corporation's crop growing expenses. In this sense, the court's statements with respect to Section 336 and the tax benefit rules were dicta that were not essential to its holding with respect to Section 446(b). Indeed, since its decision in that case, the Ninth Circuit has cast doubt upon its dicta in *South Lake Farms* by holding in two cases that neither Section 336 nor 337 bar application of the tax benefit rule to liquidating corporations. *Spitalny* v. *United States*, 430 F. 2d 195 (9th Cir. 1970) (tax benefit rule requires inclusion in income of previously-expensed cattle feed by corporation liquidating under Section 337); *Home Savings and Loan Ass'n* v. *United States*, 514 F. 2d 1199 (9th Cir.), cert. denied, 423 U.S. 1015 (1975) (tax benefit rule requires inclusion in income of bad debt reserve by savings and loan association liquidating under Section 336). These subsequent decisions, which are in accord with the rationale of the court below, suggest that the dicta in *South Lake Farms* may no longer represent the authoritative view of the Ninth Circuit with respect to the question presented in this case.[1]

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[1] In *Home Savings and Loan*, the court stated that it did not intend to impair the authority of *South Lake Farms* (514 F. 2d at 1201 n.1). But the court made that statement in the course of observing that the taxpayer in that case was not asserting that *South Lake Farms* stood for the proposition that the accrual of earned but not reserved income was improper. Thus, to the extent that the court intended to preserve the authority of *South Lake Farms*, it was with respect to its holding dealing with Section 446(b) and not the dicta addressing Section 336 and the tax benefit rule.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

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